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Oil and Gas--Depletion

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sulting from its inability to arrive at a working rule with regard to the problem of the corporate entity."[47] Although the statute does not appear to be in conformity with the ruling in this case it may be reconciled with a holding that "This section obviously has reference * * * to a transfer of its entire assets * * * or to a transfer of a part of the assets * * * that the corporation may thereafter be under one control and may be operated substantially as one *in the prosecution of his business,*"[48] and that assets to be exempt from gain must be acquired through a reorganization and not through liquidating proceedings,[49] and that reorganization "indicated readjustments of existing interests."[50] Again the court may have held in conformance with prior opinions that "earnings or profits of the original corporation remain for the purpose of distribution, earnings or profits of the successor in liquidation"[51] and "tax exemptions are never lightly inferred."[52]

Apparently the ruling in the *Gregory* case appeared too late to influence the Subcommittee of the Committee on Ways and Means in its drastic recommendation to repeal all of Section 112 of the Revenue Act in order to stay the tax evasions so prevalent under the existing reorganization definitions.[53] An opening attack on reorganization exemptions is to be found in the exclusion of Section 112 (g) from the Revenue Act of 1934—the clause under which Gregory claimed non-recognition of her gain.

IRVING DIAMOND.

OIL ANG GAS—DEPLETION.—In the first law imposing a tax upon the net income of corporations there was contained a provision permitting a deduction from gross income for depreciation of property.[1] The act by its terms made no provision for a deduction from

[47] Finkelstein, *The Corporate Entity and the Income Tax* (1935) 44 YALE L. J. 436, 440. Discussion of the corporate entity in reorganizations.

[48] Lonsdale v. Commissioner, *supra* note 24, at 539. Italics our own.

[49] See Ahles Realty Corp. v. Commissioner, 71 F. (2d) 150 (C. C. A. 2d 1934). Petitioner, a new corporation, issued all of its stock and bonds for the old corporation's assets and the old corporation dissolved, leaving its sole stockholder in control of the petitioner. *Held,* that it was a reorganization as to petitioner who therefore did not acquire assets in liquidation proceedings.

[50] Cortland Specialty Co. *et al.* v. Commissioner, *supra* note 23, at 939.

[51] Commissioner v. Sansome, 60 F. (2d) 931 (C. C. A. 2d, 1932), at 933.

[52] Heiner v. Colonial Trust Co., 275 U. S. 236, 237, 48 Sup. Ct. 80 (1927).

[53] Preliminary Report of the Subcommittee of the Committee on Ways and Means, 73d Cong., 2d Sess. (1934) 8, 9. Recommends "that the exchange and reorganization powers contained in Sec. 112 of existing law be abolished. * * * First it will close the door to one of the most prevalent methods of tax evasions."

[1] CORPORATION EXCISE LAW OF 1909, §38, 36 Stat. 112, 113. This act preceded the Sixteenth Amendment and was held to levy an excise tax, not an income tax. Flint v. Stone Tracy Co., 220 U. S. 107, 31 Sup. Ct. 342 (1911); (1934) 9 ST. JOHN'S L. REV. 228.

gross income for the depletion [2] of mines, oil and gas wells, and timber lands in arriving at the net income of corporations engaged in exploiting these natural resources, and it was later held [3] that the term "depreciation" as used in the act was not sufficiently broad to include losses sustained by the exhaustion of deposits of minerals, oil, gas, and timber.

The harsh effect of the decision was somewhat alleviated by the provision in the subsequent law [4] that there should be a "reasonable allowance" for the depletion of certain stated natural resources. The depletion allowance therein provided for was continued in the following law,[5] but in the Revenue Act of 1918 [6] an alternative depletion allowance based upon the "discovery value" of the property was permitted in those cases where mineral deposits were discovered on and after March 1, 1913. This new depletion provision was found to be difficult of application [7] and was abandoned in 1926, in which year Congress provided that there should be a depletion allowance of 27½ per cent. of the gross income from the property for the taxable year.[8] The change made by this law was welcomed by both taxpayers and Treasury officials, for the execution of the old law made it

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[2] The following explanation of the economic necessity for a depletion allowance is contained in an article by H. A. Campbell, *Depletion of Oil and Gas Properties Under the Act of 1926* (1927) 5 NAT. IN. TAX MAG. 51: "In any given space or area there are a definite number of units of coal, mineral or petroleum, the ascertainment of which is an estimate based on engineering investigations or surveys. Once removed these units can never be replaced and the taxpayer, extracting or withdrawing these units is gradually approaching a termination of his business existence unless there is formulated a policy of acquisition of additional units in a new area. To acquire such new units it is necessary to establish a reserve of capital which can be used for this purpose. The logical and only practicable method is to establish a depletion reserve, not only to enable the taxpayer to continue his useful and successful business life, but also to insure a supply of his products for the use of the nation. This reserve can only be established after the current operating needs are met. The taxpayer must first expend the necessary money to produce the oil or other mineral, and then set aside a fund to provide for a program of orderly development, operating and overhead expenses, depreciation on equipment, interest on indebtedness, and dividends. After providing for these items, it is imperative that there be established a reserve of monies with which to acquire additional units."

[3] Von Baumbach v. Sargent Land Co., 242 U. S. 503, 37 Sup. Ct. 201 (1917); (1928) 6 NAT. IN. TAX MAG. 54.

[4] INCOME TAX LAW OF 1913, §2B, G (b), 38 Stat. 166, 167, 172. The law was held to be valid even though in some cases the maximum depletion allowance was less than the actual depletion. Stanton v. Baltic Mining Co., 240 U. S. 103, 36 Sup. Ct. 278 (1916); (1917) 30 HARV. L. REV. 526.

[5] REV. ACT OF 1916, §§5 (a) (8), (12) (a) (2), 39 Stat. 756, 759, 768.

[6] REV. ACT OF 1918, §§214 (a) (10), 234 (a) (9), 40 Stat. 1057, 1067, 1078. Substantially the same provisions were re-enacted in the REV. ACT OF 1921, §§214 (a) (10), 234 (a) (9), 42 Stat. 227, 241, 256; REV. ACT OF 1924, §§204 (c), 214 (a) (9), 234 (a) (8), 43 Stat. 253, 260, 270, 284, 26 U. S. C. §§935 (c), 955 (a) (9), 986 (a) (8).

[7] REPORT No. 52, Finance Comm., U. S. Senate, 69th Cong., 1st Sess., p. 17 (1926).

[8] REV. ACT OF 1926, §204 (c) (2), 44 Stat. 9, 14, 26 U. S. C. 935 (c) (2).

necessary for the taxpayer to submit and the government to scrutinize costly and voluminous engineering data to substantiate the claim of fair market value at the date of discovery based upon the probability of productiveness as of such date.[9]

During all these years there had been coupled with the provision for a reasonable allowance for depletion of natural resources a clause stating that in the case of leases the deductions were to be equitably apportioned between the lessor and lessee.[10] With the enactment of the provision for an arbitrary depletion allowance the question arose whether the requirement that the deduction be equitably apportioned between lessor and lessee had any bearing on the case of a taxpayer-lessee who claimed the arbitrary deduction, or whether it had application only to the one who claimed a "reasonable allowance" for depletion. There likewise was presented the problem whether an amount secured by a lessor as a bonus under a long-term lease of oil and gas property was subject to a depletion allowance of 27½ per cent. during a year in which no oil was drilled.

The answer to the first problem depends upon the construction placed upon the words "gross income from the property." If we are to include within the meaning of that phrase all the income received by the lessee from all uses of the property, including the sums which the lessee is obliged to pay to the lessor as rents or as royalties. there will be an incongruous situation created in that there will be allowed by the government a 27½ per cent. depletion allowance on more than the full value of oil and gas products, or, expressed differently, the government will permit a depletion allowance to the extent of more than 27½ per cent. of the gross income from oil and gas.[11] The Supreme Court held [12] that from the legislative history of the several revenue laws and the departmental interpretation thereof it was evident that Congress intended to limit the phrase "gross income from the property" to the gross income from oil and gas, as distinguished from the entire income from sources other than oil and gas. The

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[9] Campbell, *op. cit. supra* note 2, at 71.

[10] *Supra* notes 5, 6 and 8. The provision in the 1926 law reads: "In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee." REV. ACT OF 1926, §234 (a) (8), 44 Stat. 9, 42, 26 U. S. C. §986 (a) (8).

[11] Assume that *T* leases oil and gas property from *L* under an agreement whereby *T* is to pay to *L* 50 per cent. of the gross income of the property. In a given year the gross income is $100,000. Of this sum $50,000 is due to *L*. If *T* is allowed to claim the statutory depletion allowance on the gross income, he will receive a depletion allowance of $27,500. Similarly, when *L* receives the $50,000 in royalties, he will be entitled to a depletion allowance of 27½ per cent. of said amount, or $13,750. In other words, on a gross income of $100,000 there will have been allowed by the government a depletion deduction of $41,250, or 41¼ per cent.

[12] Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 55 Sup. Ct. 174 (1934), *rev'g* Twin Bell Oil Syndicate v. Helvering, 70 F. (2d) 402 (C. C. A. 9th, 1934), which reversed Twin Bell Oil Syndicate v. Com'r of Int. Rev., 26 B. T. A. 172 (1932).

court traced the history [13] of the various revenue acts and, by close attention to details in the construction of these laws and particularly those later laws which contain amendments [14] designed to remove the uncertainty caused by the Revenue Act of 1926, it reached its conclusion that the depletion allowance of 27½ per cent. was subject to equitable apportionment between the lessor and lessee.[15]

The solution of the problem whether a lessor of oil and gas property is entitled to a depletion allowance in respect to a bonus received from the lessee during a taxable year in which the land is not productive and is not likely to become so is dependent upon the result which would follow refusal to allow a depletion deduction.[16] If the law were so framed as to provide that in case the land were to produce large quantities of oil and gas in a subsequent year the taxpayer might in such year have full allowance for the actual depletion suffered in such year, no injustice would be done to him in requiring him to forego a depletion allowance upon a bonus received during a year in which no oil or gas was produced. However, it is settled that the depletion allowance permitted by the statute may be availed of only during the year in which the depletion actually occurred and that deductions which were not allowed in one year

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[13] Helvering v. Twin Bell Oil Syndicate, *supra* note 12, at 315 *et seq.*

[14] "In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property." REV. ACT OF 1932, §114 (b) (3), 47 Stat. 169, 202, 26 U. S. C. §114 (b) (3).

"This amendment makes it clear that in computing the gross income from the property, the allowance for percentage depletion in the case of oil and gas wells, there shall be excluded from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property." REPORT No. 1492, Conference Comm., House of Rep., 72d Cong., 1st Sess., p. 14 (1932).

In the REV. ACT OF 1934, §114 (b) (3), 48 Stat. 680, 710, 26 U. S. C. §114 (b) (3), the section was further clarified by the insertion after the word "depletion" of the words "under section 23 (m)." The section referred to is the provision which permits a "reasonable allowance" for depletion.

[15] It is the opinion of the writer that had no correcting amendment been passed prior to the decision in the present case the reversal of the lower court would not have been unanimous. The fact that a later Congress declared that the amendment was "corrective" and not a change from the law of 1926 may have had some weight with the court. But is it proper to be guided by the declarations of a subsequent Congress in reference to a poorly expressed intent of a Congress which had long passed out of existence? There would appear to be occasion to apply the principle of law that inconsistencies and ambiguities in a tax law are to be construed in the taxpayer's favor.

[16] The Treasury Department had established the rule that a depletion allowance was to be permitted only in case future production was practically assured by reason of the existence of nearby wells and geological indications or oil or gas in some amount, however small, was produced during the taxable year. If the producer's chance of securing oil or gas was speculative and no oil or gas was produced during the taxable year, then no depletion allowance was made even though in a subsequent year the land yielded large quantities. G. C. M. 11384, XII-1 Cum. Bull. 64 (1933).

may not be claimed in a subsequent year;[17] therefore, extraordinary depletion in one year may not be compensated for beyond the sums actually received by the lessor during such year. It would follow from this premise that a lessor would be denied the statutory depletion deduction in cases where the land suffered no actual depletion and would be permitted to claim the full allowance if only a few barrels of oil or a few cubic feet of gas were produced.[18]

The Supreme Court refused to give its sanction to any such unreasonable rule and held that such bonus payments should be subject to a depletion allowance during the year in which they were received,[19] and left open for future determination whether a lessor who has received a bonus on oil and gas lands which were never productive during the term of the lease may in the final year of the lease be obliged to pay a tax upon those sums which had been previously free from taxation as depletion allowances.

JOHN F. MITCHELL.

TAXATION—DEDUCTION OF AMORTIZED COMMISSIONS ON BONDS ISSUED PRIOR TO 1913.—Prior to 1913, the taxpayer sold three issues of bonds at a discount and paid to bankers an additional amount as commissions for marketing the bonds. The taxpayer kept its books and made its tax returns on the accrual basis. A deduction from gross income representing the amortized amount of the commissions and discount was disallowed by the Commissioner of Internal Revenue who found a deficiency in each of the taxable years, 1918 to 1923 inclusive. The Board of Tax Appeals ruled that the petitioner was entitled to the deduction for the discount, but not for commis-

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[17] "The tax is an income tax for 1918, and in the absence of express provision to the contrary, it is not to be supposed that the taxpayer is authorized to deduct from this year's income depreciation, depletion, business losses or other similar items attributable to other years." Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, 306, 51 Sup. Ct. 418 (1931).

[18] Dissenting opinion of Sibley, J., in Herring v. Com'r of Int. Rev., 70 F. (2d) 785, 788 (C. C. A. 5th, 1934).

The injustice of the rule may be seen in this supposed case:

L leases oil and gas property to *T* for five years. *L* is to receive 25 per cent. of the income in royalties and is to receive each year $50,000 as a bonus or advance royalty, such amount to be credited upon sum due to *L* from *T* when production is actually commenced. For four years *T* fails to commence drilling. During each year *L* receives $50,000, or a total of $200,000. During the final year *T* produces $800,000 worth of oil. *L's* share of this is one-fourth, or $200,000, which he has already received. Therefore, during the final year *L* has no income from the property and has been deprived of any depletion allowance. Yet, had *T* produced one barrel of oil during each year, *L* would have been entitled to a full depletion allowance.

[19] Herring v. Com'r of Int. Rev., 293 U. S. 322, 55 Sup. Ct. 179 (1934), *rev'g* Herring v. Com'r, *supra* note 18.